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Markets in High Resolution

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Coronavirus Guesswork

I know we can't expect to become virologists overnight. But investors need to map out what we know, what we might know, and what we don't know, in order to gain some sense of risk and reward amidst the newfound volatility.

Many are downplaying the coronavirus by saying "well, the flu does XZY and markets don't sell off over the flu every year." I'm afraid that's too simplistic. There are worst case scenarios here that could have meaningful ramifications for Chinese systemic risk and global growth. They need to be rationally handicapped. Here's my attempt:

- This is what a Chinese train station can look like at the peak of the Spring Festival migration:

- Peak pre-holiday travel occurred a week to 10 days ago. The virus supposedly has an incubation period of 10-14 days, although symptoms can appear as soon as 1-2 days in some cases. Carriers can transmit the disease prior to becoming symptomatic, but it's unclear how prevalent that phenomenon. **The next few days should provide critical data** on how widely and broadly the virus spread beyond Wuhan coincident with the holiday migration.

- Lost holiday sales are a drag on reported GDP but don't create a systemic risk (except perhaps in Hong Kong where many businesses were already teetering).

- The bigger problem for China – with potential for spillovers – is a significant disruption to post-holiday industrial activity. The industrial sector is debt-stressed, with limited capacity to endure any significant reduction in cash flows. **Widespread disruption to Chinese industrial activity will require a monetary policy response** with ramifications for the RMB, and by extension EM more broadly.

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Chinese regulator requires banks and relative institutes not to withdraw, stop or delay loans to those enterprises, including wholesale and retail, accommodation catering, logistics and transportation firms, that are affected by #WuhanCoronavirus.

- Nationwide, business was set to resume this Friday (1/31). That has now been officially extended to Monday, February 3rd. However, municipal authorities in Shanghai announced that local business will not re-open until Feb 9th.

- I would anticipate a further delay to business re-opening nationwide due to the **problematic nature of stuffing hundreds of millions people on to crowded train stations before the virus is fully under control**. Markets should react negatively to any nationwide extension of the holiday to Feb. 9 or beyond.

- The danger posed by travel could exacerbate the burgeoning trend of "reverse migration," in which migrants fail to return to the cities for work. This is a normal phenomenon in times of slow economic growth, and could be compounded by present circumstances.

- A multi-week closure of a significant swathe of Chinese industry could have a knock-on effect on Asian growth and global commodity markets, as well as creating noticeable supply chain disruptions. It's also likely to prove the **death knell for China's "deleveraging campaign,"** with ramifications for perceived financial system risk and the RMB.

- This event could exacerbate the inevitable tension between China's perceived FX stability commitment and the ever-present need for easy monetary policy. **It's a bad time to be trying to defend the RMB**.

- A wildcard conspiracy theory with significant foreign policy ramifications: China's only accredited lab working with deadly pathogens is in Wuhan. There were warnings in 2017 about the possibility of a pathogen escaping. Science magazine suggests that descriptions of the early cases do not support the theory that the outbreak originated in the Wuhan wildlife market. A verifiable link to the lab would be a major blow to the Chinese government's credibility.

- I'll acknowledge a "better lucky than smart" element to my decision to cut out of equity risk late last week, but the bid tone to the Dollar and the Treasury markets were signaling vulnerability. **Markets are not well-placed to deal with the emergence of a significant new "known unknown."**

- I'll consider re-entering equity and EM risk once signs emerges from China that the situation is stabilizing – either a discernible decline in the daily rate of emergence of new cases, or a central government commitment to reopening businesses on Feb 3rd. Until then, **the risk of emergence of a large number of cases outside of Wuhan** is a deterrence to re-engaging with high-beta assets.

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- A bit of bullish news for China: it looks like the U.K will announce tomorrow some role for Huawei in the country's 5G network. This is a big win for Huawei and a huge blow to U.S. efforts to immunize Western tech infrastructure from the risk of Chinese intrusion. On a parallel track, the Trump Administration is reportedly convening a cabinet-level meeting this week to hash out the inter-agency squabble between Commerce and Defense / Treasury on a tightening of export restrictions on Huawei. Failure to bring the UK on board undercuts the case for a tightening of controls.

- The U.K's decision will force the U.S. to either **stand down or double down** on the Huawei pressure campaign. Legislation to ban intelligence sharing with countries allowing Huawei into their 5G networks could begin to move shortly.